EXHIBIT 2
DATE 1-5-07
HB 72

# Working for Montanans since 1915.

## An Overview of Montana's Workers' Compensation System

MONTANA
STATEFUND



## History of workers' compensation

The need for a fair and equitable system of workers' compensation evolved out of the industrial revolution. As economic and industrial activities flourished, the number of work injuries also grew. This problem was first addressed in Europe during the 1800s, and by the turn of the century the movement had spread to the United States. Laws were enacted by most states in the early 1900s to provide workers injured on the job with prompt, equitable, and guaranteed benefits. Injured workers received medical care and disability income irrespective of fault. Employers, in turn, were protected from potentially catastrophic loss by a specific benefit amount for the injuries suffered by the employee. The worker was prohibited from filing suit while the employer was obligated to pay the mandated benefits. This compromise is known as "exclusive remedy," and still is the basis for our workers' compensation system today.

*Workers' compensation insurance ensures injured workers receive medical care and wage-loss benefits, while protecting employers from potentially catastrophic loss.*

## How does workers' compensation differ from other types of insurance?

Workers' compensation benefits are defined in law for both indemnity (wage loss) and medical payments. However, unlike health insurance, there are no deductibles or caps on medical benefits. For workers' compensation insurance, premiums are established long before the number, severity, duration, or cost of claims can be known. Case and actuarial reserves are established as claims occur, but the ultimate cost of those claims is not known for many years, sometimes taking as long as 30 to 40 years. Catastrophic and/or unanticipated events may also occur which are not covered by annual premiums. Because of this, workers' compensation is quite different from all other goods and services where the price is established after most costs of production and delivery are known. Insurers need to maintain significant reserves and contingency funds to ensure that they are able to meet their long-term obligations.

*Because long-term obligations are unpredictable, workers' compensation insurers must maintain significant reserves and contingency funds compared to other types of insurers.*

## Why is there a Montana State Fund?

In most states (including Montana) workers' compensation is mandatory and employers must purchase insurance coverage or be subject to penalties and exposure to lawsuits by employees. With enactment of state workers' compensation laws, the need for workers' compensation insurance created its own set of problems. Employers feared they would be forced out of business if refused coverage by insurance companies. They were also worried that insurance carriers might deny coverage or impose excessive premium rates that would be a financial burden. In response, state legislatures provided for a guaranteed market for workers' compensation insurance by implementing **one of three models:**

### 1. A Competitive State Fund:

This is the system that has basically been in place in Montana since 1915, which gives employers three options for purchasing their insurance:

- Develop a self–insurance program (plan 1)
- Purchase from a private company (plan 2)
- Purchase from Montana State Fund (plan 3)

This system provides the most options and flexibility for employers. It also protects the interests of the majority of Montana businesses by fostering a competitive marketplace, resulting in pricing that can be as low as

## Timeline of key events related to workers' compensation issues (1987-2005)

**July 1, 1987**
- *Payroll tax of 0.3% placed on employers because of the unfunded liability in the State Fund (Old Fund).*

**1989 regular legislative session**
- *Creation of State Compensation Insurance Fund as a domestic mutual with regulation by the Insurance Commissioner.*

prudently possible. While MSF does not pay taxes because of its public, non-profit status, it must serve as the guaranteed market for Montana businesses and cannot refuse to insure except for non-payment of premium. It cannot leave the state when there are adverse market conditions. Montana comprises a mere four-tenths of 1% (0.4%) of the national workers' compensation market. Private carriers have the ability to move in and out of a market based on opportunity. Montana State Fund offers employers a stable, locally controlled, reliable, and competitively priced source for workers' compensation insurance.

*All Montana businesses are required by law to carry workers' compensation insurance. Montana State Fund offers employers a stable, locally controlled, reliable and competitively priced source for workers' compensation insurance.*

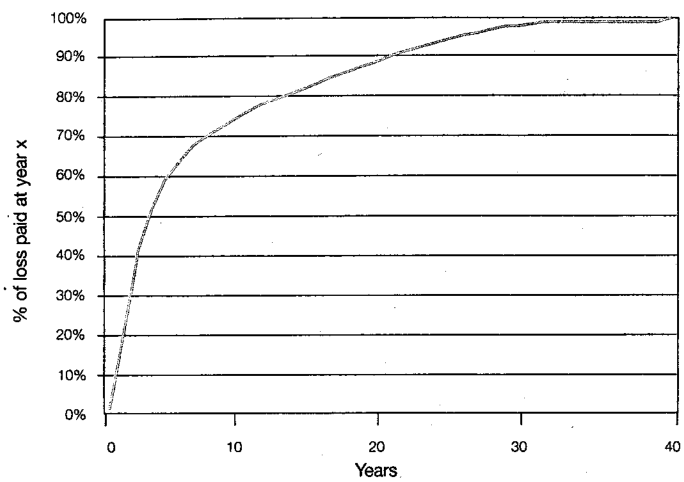
## 2. Assigned Risk:

There are a number of instances in which private insurance carriers reject both small and large businesses for workers' compensation insurance. When an employer cannot get coverage, they are put into the assigned risk pool and are "assigned" to an insurance company. Assigned-risk pools often have rates higher than the voluntary market.

## 3. State Monopoly:

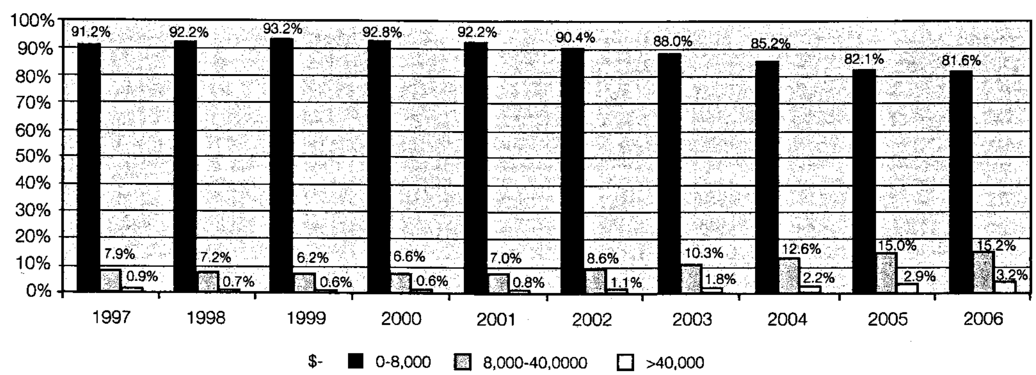
In monopoly states, all coverage is provided by a state agency (State Fund). There are no private insurers and no competition. This is the system in use by the states of Washington, Wyoming, North Dakota, and Ohio.

**Estimated Accident Year Payout Pattern**




*For claims incurred in any given year, it takes about 30-40 years for the last dollar on the last claim to be paid. For this reason, workers' compensation is known as a "long-tailed line of insurance." We can only make educated guesses at what each year's claims will cost until several decades have gone by. Most claims close within about three years but the small number which remain open beyond that point account for over half of the total costs.*

**Policyholders by Premium Size**




*The vast majority of MSF policyholders pay less than $8,000 in annual premiums. MSF insures businesses in all 56 counties and virtually all small business operations in the state.*

- *HB 56–Transfer of $20 million from the General Fund to workers' compensation tax account.*

1989
June special session

- *Payroll tax on employers modified to 0.28%.*
- *Liability of State Fund separated into claims that occurred before July 1, 1990 (Old Fund), and claims that occurred on or after July 1, 1990 (New Fund — now called Montana State Fund).*
- *The Old Fund became funded by the payroll tax. MSF would administer the Old Fund on behalf of the legislature, but have no liability or funding responsibilities.*
- *MSF received $12 million start up and then became funded solely by insurance premiums and investment income from premiums.*
- *Any dividends declared by MSF were required to be transferred to the Old Fund.*
- *Legislative oversight was increased and regulation by the Insurance Commissioner ended June 30, 1990.*

May 1990
special session

## Montana State Fund operations

By law, MSF is designed to be self-supporting from premium and investment revenue. It is not funded by taxpayers' dollars, but was created by the legislature to function as a self-supported insurance company conducting business in a competitive market.

Because it is a public entity, Montana State Fund is subject to open meeting laws and constitutional requirements in regard to investments. However, recognizing that MSF needs to operate competitively, the legislature has granted exceptions from state pay, classification, employee leave plans, budgeting, and certain purchasing requirements. MSF is attached to the executive branch of government through the Department of Administration.

## Legislative oversight

The legislature maintains ultimate oversight over MSF. The legislative audit division (LAD) performs an annual review to ensure that MSF is being run on an actuarially sound and fiscally responsible basis. Montana State Fund provides all legislators a copy of the annual report and strategic business plan on an annual basis.

## Board of Directors oversight

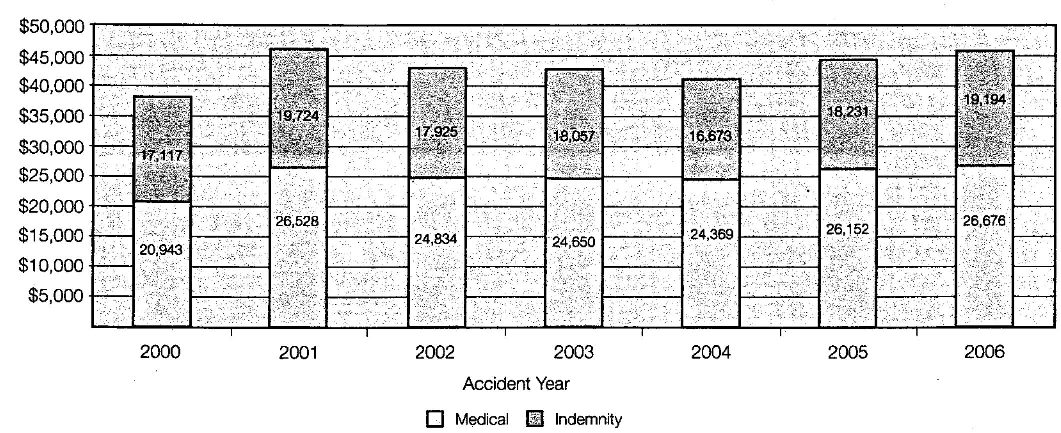
The Governor appoints MSF's board of directors. The board consists of seven individuals who must meet certain eligibility requirements and serve a four-year term on a staggered basis. In Section 39-71-2315, MCA, the legislature granted the management and control of the state fund to the board.

The board's specific responsibilities include: rate-making, declaration of dividends, approving an annual strategic business plan, establishing the annual operating budget, determination of appropriate surplus levels, and submission of an annual financial report. The board utilizes major independent accounting and actuarial firms to validate the funds' financial position and reserves, and has the responsibility to hire a CEO of the state fund (Section 39-71-2317, MCA).

*By law, MSF is to be self-supporting from premium and investment revenue, and is not funded by taxpayers' dollars.*

**Average Cost per Wage-Loss Claim Incurred by MSF**

*The average wage-loss claim costs about $45,000, although the most catastrophic of claims can cost as much as several million dollars. About 60% of workers' compensation claim costs are for medical services and is a fast growing driver of claim costs.*




- *Payroll tax on employers was increased to 0.5%.*
- *Payroll tax of 0.2% placed on employees, sole proprietors, partners, subchapter S-corporation shareholders and members or managers of LLCs.*

1993 regular legislative session
Addition to payroll tax

- *MSF Board Meeting: dividend returns money to state. The $103 million dividend repays $12 million initial funding and pays down Old Fund bonds.*

September 14, 1996

- *MSF repaid $20 million received by the Old Fund under HB 56 to the General Fund.*
- *SB 67 ended the requirement that dividends must be paid to the Old Fund and set up the test under which the payroll tax could terminate. MSF transfers $63.8 million to the Old Fund.*

1997 regular legislative session

## Workers' compensation and the legislative process

In each session, there are on average more than 30 bill draft requests regarding workers' compensation issues. A number of these have to do with how benefits are determined and paid, as well as modifications to existing laws.

There are a number of constituencies that are actively involved in the legislative process, including but not limited to:

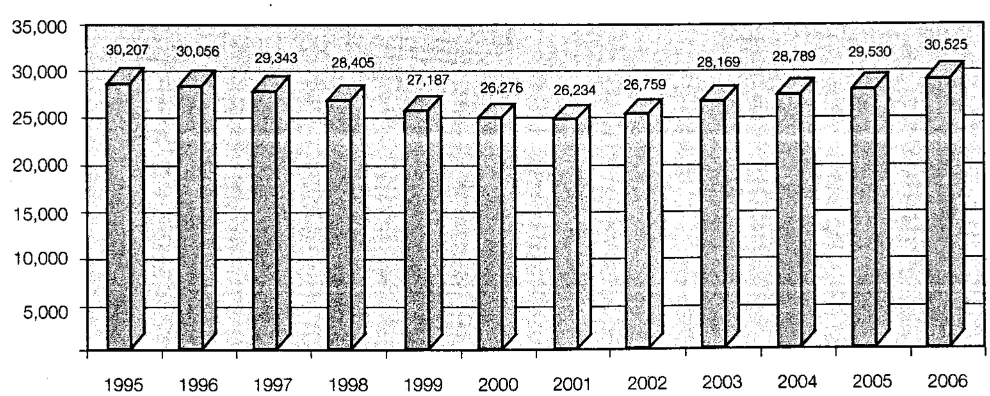
- Employee groups
- Business organizations
- Self-insured organizations
- Attorneys
- Insurance carriers
- Medical providers
- State auditor's office

Most laws related to workers' compensation are found in Title 39, Chapter 71, of the Montana code. Generally speaking, bills have their first hearing in either the House or Senate Business and Labor committees. The Department of Labor is the regulator of the workers' compensation system and their expertise is often called upon.

The judiciary plays an active role in interpreting how workers' compensation laws are applied. Disputes that cannot be resolved in the Workers' Compensation Court are appealed to the Supreme Court. The findings of the Supreme Court can have far-reaching ramifications for the workers' compensation system, which may in time result in legislative action.

*On average, more than 30 bill draft requests regarding workers' compensation issues are made each legislative session. Most related laws can be found in Title 39, Chapter 71, of the Montana code.*

**Policies Written by MSF**




*Since the late 1990s, private carriers have been reducing their exposure in Montana due to a number of factors. A private carrier can enter or exit the market at will. As the guaranteed market, MSF insures any Montana business, offering employers a stable, locally controlled, reliable, and competitively priced source for workers' compensation insurance.*

- *Payroll tax terminated as Old Fund meets the criteria to be considered "adequately funded."*

December 31, 1998

- *SB 19 transferred $4 million of Old Fund excess to General Fund and set up study committee to report to the 58th legislature on the structure of Montana State Fund.*

2002 special session

## The legislature's role in creating the Old Fund and the New Fund

### Background

Between 1987 and 1993 the legislature wrestled with major issues in our state's workers' compensation system. At the core was an unfunded liability of more than $500 million in claim benefits due to injured employees. During the 1980s, workers' compensation insurance premium rates were influenced by the political process rather than actuarially sound analysis. Rates were set at artificially low levels even as payouts increased. Because losses far exceeded premiums collected, the unfunded liability grew at a staggering rate, jeopardizing the entire system. In addition, the underpriced market essentially forced private carriers — who could not remain competitive and still profitably write coverage — to leave the state. Their departure meant that Montana businesses had fewer options for their insurance and placed a greater burden on a flawed system. Once it became clear that the structure was no longer workable, the legislature found it necessary to intervene. During the 1987 session, they made the difficult and unpopular decision to enact a 0.3% payroll tax on employers to raise revenues. However, stricter measures needed to be taken.

In 1989, one of the most critical issues confronting the legislature was trying to bring some semblance of order back into the workers' compensation system.

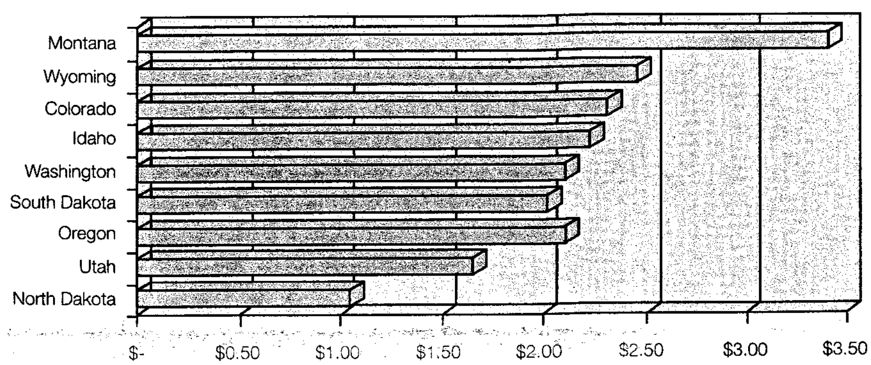
Recognizing that the state's workers' compensation system was in need of a major overhaul, the legislature created a new entity, the State Compensation Mutual Insurance Fund (State Fund). State Fund was structured to operate as a domestic mutual insurance company, and as such, function independently of state agency requirements.

In order to bring more revenue into the system, rates for workers' compensation coverage needed to rise dramatically. However, there was tremendous resistance to rate increases of the magnitude that would be needed to effectively deal with the problem. In June 1989, there was a special session convened which appropriated $20 million of the General Fund to State Fund.

Saddled with mounting liabilities, State Fund would need a dramatic increase in rates to achieve balance in the system. The uproar created was vocal and swift. Increases of this magnitude would be devastating to existing or new businesses in Montana, and were simply unacceptable. It was increasingly apparent that a bold, innovative solution needed to be found to resolve the crisis once and for all.

The legislature reconvened in a special session in May 1990 and took a different approach. Realizing that saddling State Fund with an astronomical debt was unworkable, they separated the liability into claims occurring before and after July 1, 1990. Claims occurring before this date became known as the Old Fund. Any claims after that date became the responsibility of the New

**Average Workers' Comp Premium Rate**




*Montana was ranked as having the eighth highest workers' compensation premium rates in the nation as of January 1, 2004, based on a biennial study by the Oregon Department of Consumer and Business Services. Montana workers' comp rates are the highest in the region. These results take into account differences in the types of industry found in each state. The National Council on Compensation Insurance observes that the Montana workers' compensation system experiences significantly more permanent partial disability claims than other western region states.*

- *HB 363 removed the reserve requirements from the Old Fund and transferred $18.2 million, as well as any future excess, to the General Fund from the Old Fund.*
- *SB 304 created an interim committee to study the structure and role of MSF, and if it would be in the best interest of the state to sell either the Old or New Fund. The committee was tasked with making recommendations to the 2005 legislature.*
- *SB 360 stipulated that the legislature cannot transfer monies from Montana State Fund to be used for other funds or other programs.*

2003 regular legislative session

Fund (now known as Montana State Fund, or MSF). In doing this, they determined that the Old Fund liabilities would be funded by an increased payroll tax on employers and employees. Bonds were sold to cover the unfunded liability and were serviced by proceeds from the payroll tax. MSF administers the Old Fund on behalf of the legislature (MSF is reimbursed for the cost of administering the claims) but has no liability or funding responsibilities. It was the intent of the legislature that Montana State Fund be run in a business-like manner, solely funded through insurance premiums and investment income. MSF began operations on July 1, 1990.

There are approximately 1,000 open claims remaining in the Old Fund, with discounted estimated obligations of $73.7 million as of June 30, 2006. Actuarial predictions are that the final claim will not be paid out until 2045. When the funds in the Old Fund are depleted, the state of Montana and the general fund are obligated to cover any benefit payments.

*Old Fund reserves estimated to be adequate through 2013, as of June 30, 2006.*

## Current situation

**The Old Fund liability of $500 million was financed through a combination of payroll tax collections (68%) and monies transferred from MSF (32%). The key events are:**

**1989**

*$20 million appropriation of General Fund money to the Old Fund.*

**1987–1998**

*$349 million in payroll tax collections.*

**1996–1998**

*$166 million paid by Montana State Fund to eliminate the Old Fund liability and allow for payments of dividends to policyholders. In recognition of the payment, legislature allowed for any excess beyond actuarial projection in Old Fund to be transferred back to MSF.*

**1997–1998**

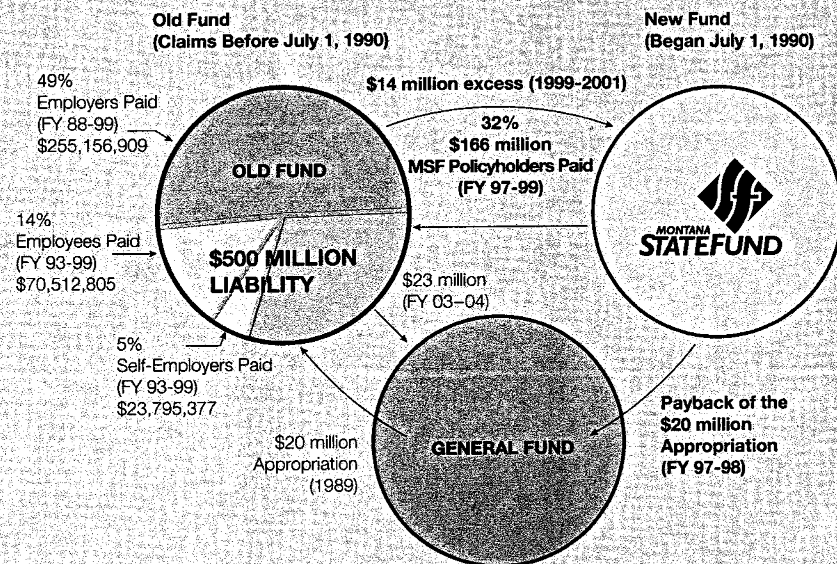
*MSF paid back the 1989 appropriation of $20 million to the General Fund.*

**1999–2001**

*$14 million in excess returned to MSF.*

**2002–2003**

*$23 million transferred as legislature determined that all existing contingency reserves and any excess from Old Fund should go to General Fund.*




- *$800,000 of Old Fund excess transferred to General Fund for a total of $23 million.*

- *SB 61 creates legislative liaisons to MSF board. Two legislators were appointed as non-voting liaisons to the board. They attend all meetings and receive all board materials. The SB 304 committee determined there would be no sale of MSF and therefore maintained the current structure of MSF as a public, non-profit competitive state fund with the responsibility of being the guaranteed market for Montana businesses.*

April 2004

2005 regular legislative session

## Glossary of workers' compensation terms

**Classification codes:** The classification system groups employers so the rates reflect common exposures. The class code assigned best describes the business and includes all types of labor. The business is classified—not separate employments or occupations. Policyholders report payroll and pay a premium based on the classification codes assigned to their policies.

**Exclusive Remedy:** The premise on which the workers' compensation system is based: workers give up the right to sue their employer in exchange for wage loss and medical benefits for their injuries and occupational diseases.

**Experience Rating:** A mandatory program that modifies an employer's premium based on a comparison of their experience with the expected experience of an average employer using the same class code(s). The experience modification factor either increases or decreases premium.

**Impairment Rating:** A medical term that is sometimes confused with disability. An impairment rating is a medical determination where the medical provider assigns a numerical rating for whatever type of bodily function has been lost, based on the AMA Guides to the Evaluation of Permanent Impairment.

**Incurred Losses:** The total of the reserves and paid amounts for claims.

**Indemnity Benefits:** Payments to a worker with an injury or occupational disease representing wage-loss benefits.

**Independent Medical Examination (IME):** An examination by a physician, psychologist or panel to obtain an independent evaluation of the employee.

**Manual Premium:** Payroll, divided by 100, multiplied by the manual rate for the classification code(s) assigned a business.

**Maximum Medical Healing (Medical Stability or Maximum Healing):** A term used by the medical provider to indicate when further material improvement in the healing process would not be expected by a worker with an injury or OD.

**Medical-only Claims (MO):** Claims with only medical bills and no indemnity benefits owed or paid.

**National Council on Compensation Insurance, Inc. (NCCI):** National Council on Compensation Insurance, Inc., manages the nation's largest database of workers' compensation insurance information. NCCI analyzes industry trends, prepares workers' compensation insurance rate recommendations, determines the cost of proposed legislation, and provides a variety of services and tools to maintain a healthy workers' compensation system.

**New Fund:** Claims occurring on or after July 1, 1990, and, by law, the responsibility of Montana State Fund.

**Occupational Disease (OD):** A medical condition resulting from employment-related activities that occur over a period of time and not from a single traumatic event on a single day.

**Old Fund:** Claims occurring before July 1, 1990, and, by law, the financial responsibility of the state of Montana.

**Permanent Partial Disability (PPD):** A condition in which the worker is able to return to work, but has wage loss and a permanent impairment.

**Permanent Total Disability (PTD):** A condition in which the worker is not able to perform regular employment.

**Rehabilitation Benefits:** Benefits provided to a disabled worker who has a permanent impairment, job limitations and an actual wage loss, or a worker with an impairment rating 15% or greater, to assist the worker in returning to work following a work-related injury or OD.

**Reserves:** The estimated value of the benefits and claim costs expected over the life of a claim. Paid amounts are not included in the reserve.

**State Average Weekly Wage:** Established annually by the Department of Labor and Industry, it is the basis for determining maximum weekly benefits under the Workers' Compensation Act.

**Social Security Disability Benefits (SSDI):** SSDI benefits are payable to disabled individuals through the Social Security Administration.

**Surplus:** A retained earnings account intended to assure that the insurer will be able to fulfill its obligations to policyholders and injured employees. When an insurer reports a surplus, they are not talking about unneeded or excess funds.

**Temporary Partial Disability (TPD):** A worker prior to maximum healing who can temporarily return to work in a modified or alternative employment, but suffers a partial wage loss, can receive this wage-loss benefit.

**Temporary Total Disability (TTD):** A physical condition resulting from an injury or occupational disease that results in total loss of wages and exists until the worker reaches maximal medical healing.